Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Allocation of Costs Associated with	)	CC Docket No. 96-112
Local Exchange Carrier Provision of	)	
Video Programming Services	)	

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REPLY COMMENTS OF
THE NATIONAL CABLE TELEVISION ASSOCIATION, INC.

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June 12, 1996

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SUMMARY

NCTA is pleased that commenters in this rulemaking, with the exception of the incumbent local exchange carriers (LECs), agree that the Commission's cost allocation rules must be revised to reflect an era of integrated networks. Further, there is widespread agreement with the Commission's tentative conclusion to use a fixed factor to allocate common costs in order to prevent cross-subsidization as well as agreement on including local telephone ratepayers in any scope economies of integrated networks. NCTA encourages the Commission to adopt cost allocation rules consistent with these areas of agreement.

The Commission's Notice, and the comments filed by a diverse group of competitors and consumers (and the Federal Government, through GSA) recognize the need for clear, administratively simple cost allocation rules. Despite LEC claims to the contrary, the periodic reviews and profit sharing mechanisms of price cap regulation preserve the incentive to cross-subsidize in order to decrease costs (or increase revenues) of unregulated competitive ventures by increasing costs (or decreasing revenues) of regulated services. The attached paper prepared by Dr. Leland L. Johnson shows that properly configured cost allocation rules are necessary and will help to prevent LECs from engaging in cross-subsidization under a price cap regime.

The unprecedented level of common costs resulting from the joint provision of video and telephone services further necessitates clear cost allocation rules. In addition, cost allocation rules will benefit providers of competitive services, such as OVS, who must justify to the Commission that their rates are just and reasonable. Hence, properly configured cost allocation rules will protect local ratepayers and telephone companies alike as the effects of competition change the way in which telecommunications services are offered.

To achieve the goal of sharing with local ratepayers the scope economies of integrated networks, the Commission should reject LEC assertions that current price cap productivity factors adequately share efficiency gains with ratepayers. To the contrary, the Commission must do more than simply rely on existing measures to adequately share any benefits of integrated networks with local ratepayers. The Commission should appropriately adjust the LECs' price cap indices to reflect any scope economies.

The solution proposed by NCTA in its comments would achieve these goals for the Commission. NCTA proposes the Commission allocate 75% of common costs to nonregulated services and 25% of common costs to regulated services. Further, the Commission should use the costs of a state-of-the-art stand-alone telephone network as a ceiling to ensure that no more costs are allocated to the telephone side of the network than would be the case in the absence of an integrated network. Finally, the Commission must reduce the price cap indices of the incumbent LECs to ensure that local ratepayers share in the economies of scope resulting from network integration. To the extent that incumbent LECs argue against NCTA proposals in order to maintain opportunities to cross-subsidize, their arguments must be rejected. The preservation of universal service, statutory requirements, and principles of sound economic policy require the Commission to follow this course.

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I. INTRODUCTION

NCTA is heartened by the overwhelming agreement among commenters, with the exception of the incumbent local exchange carriers ("LECs"), that the Commission's tentative conclusion to adopt a fixed cost allocation factor is the preferred method for allocating the costs of an integrated network in order to prevent cross-subsidization.[1] The LECs take a contrary view, which we believe is not supported either by the law or by the economics developed in the record in this proceeding.

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[1] See Comments of NCTA at 16-17; Comments of Cox Communications at 8; Comments of Time Warner Cable at 10-11; see also Comments of Comcast Cable Communications at 7 (advocating at least 70% allocation to nonregulated services); Comments of General Services Administration at 4 (advocating an allocation of 72% to video); see also Comments of the Pennsylvania Office of Consumer Advocate at 1 ("At least 50% -- and possibly much more -- of the broadband loop costs must be allocated to video services for which that broadband network is being built."); Comments of MCI at 10 (advocating allocation of 55-60% of common costs to nonregulated activities); Comments of the People of the State of California and the Public Utilities Commission of the State of California at 4 (recommending a "fixed allocator of a minimum of 50% of loop costs to video and other nonregulated services" coupled with a "cap on the amount allocated to telephony."); Comments of the California Cable Television Association at 19-20 (advocating an allocation of 76% to nonregulated services); Comments of Continental Cablevision, Inc. at 4-7 (If allocated on the basis of bandwidth utilization, according to Continental's engineering expert David Fellows, "the ratio of video to telephony service utilization is 45:1.")

II. THE NOTION THAT NEW COST ALLOCATION MEASURES ARE UNNECESSARY IS MISGUIDED AND CONTRARY TO THE EXPRESS PROVISIONS OF THE TELECOMMUNICATIONS ACT

In their comments, the local telephone companies uniformly contend that cost allocation rules are unnecessary and, particularly with respect to those LECs operating under pure price cap regulation, existing rules should be applied sparingly or not at all.[2] They claim the presence of competition and price cap regulation eliminates the regulatory relevance of cost allocation.[3] With respect to price caps in particular, the LECs maintain that "pure" price caps "break the link" between prices and costs, and remove the incentive to cross-subsidize regulated ventures because a price cap-regulated LEC receives no reward for incurring high regulated service costs. Despite LEC claims to the contrary, however, competition is not a significant force, and regulatory authorities must continue to examine costs because cross-subsidization remains a considerable and very real threat.

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2 See Comments of Ameritech at 2; Comments of Bell Atlantic at 2; Comments of BellSouth Corporation at 4; Comments of GTE at 2; Comments of NYNEX at 5; Comments of Pacific Bell and Nevada Bell at 3; Comments of the Southern New England Telephone Company at 4; Comments of Southwestern Bell at 4; Comments of U S WEST, Inc. at 5; and Comments of United States Telephone Association at 2.

3 The LECs made similar arguments about the presence of competition nearly a decade ago in the MFJ Triennial Review. See, e.g., United States v. Western Electric Co., Civ. Action No. 82-0192, Comments of Southwestern Bell Corporation on the Report and Recommendations of the United States Concerning Line of Business Restrictions, at 47 (D.D.C. March 13, 1987) ("SBC is on record as supporting and endorsing the concept of cost allocation rules as appropriate safeguards to prevent cross-subsidization from regulated activities to unregulated activities."); see also United States v. Western Electric Co., Civ. Action No. 82-0192, Comments of NYNEX Corporation on the Department of Justice's Report Concerning the Line of Business Restrictions Contained in the Modified Final Judgment at 26 (D.D.C., March 13, 1987) ("In areas such as directory, CPE and intraLATA networks, those companies, formerly Bell System Companies, including AT&T, compete aggressively with one another. . . . Any attempted cross-subsidization will be policed and detected.").

Congress evidently agreed. Pursuant to the 1996 Telecommunications Act, interconnection and network element charges shall be "based on the cost . . . of providing the interconnection or network element."[4] Charges for transport and termination are not considered "just and reasonable" unless they "provide for the mutual and reciprocal recovery by each carrier of costs associated with the transport and termination of . . . calls,"[5] and are to be based upon the "additional costs"[6] of termination. Wholesale prices are to be determined on the basis of "costs that will be avoided."[7] Finally, to protect universal service the Commission is directed to vigorously protect against the danger of cross-subsidy through the establishment of "cost allocation rules."[8]

Both the practical reality of price caps and statutory directive emphasize the necessity of cost allocation rules to prevent cross-subsidization. Price caps are not relied on in the Act as a sufficient protection to prevent cross-subsidies although they have been in place for years. The Commission is correct in concentrating on adopting the appropriate cost allocation mechanisms for the provision of nonregulated services by incumbent LECs.

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4 47 U.S.C. § 252(d)(1)(A)(i) (emphasis supplied)

5 Id. at § 252(d)(2)(A)(i) (emphasis supplied).

6 Id. at § 252(d)(2)(A)(ii) (emphasis supplied).

7 Id. at § 252(d)(3) (emphasis supplied).

8 See 47 U.S.C. § 254(k) ("The Commission . . . shall establish any necessary cost allocation rules . . . to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.") (emphasis supplied).

A. The Periodic Reviews and Sharing Mechanisms Involved In Price Cap Regulation Preserve Incentives To Cross-Subsidize.

A LEC operating under price caps unquestionably has less incentive to increase the costs of its regulated services than does a LEC operating under rate of return regulation.[9] However, although price cap regulation offers improvements over traditional rate of return regulation, it fails to completely eradicate the incentive to cross-subsidize due to the periodic review process and sharing mechanisms involved in price cap regulation.[10]

Attached to these Reply Comments is a study by Dr. Leland Johnson, who provided an analysis to our original comments. His paper responds to affidavits and arguments on cross-subsidies in LEC comments. As Dr. Johnson points out, "Price cap regulation can best be regarded as resembling rate-of-return regulation with a formal time lag."[11]

Regulatory bodies periodically review the profits of a LEC regulated by price caps to ensure that the return earned by the regulated LEC is just and reasonable. Excessive profit levels maintained over an extended period of time likely will result in the regulatory body lowering the

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9 See In the Matter of Computer III Remand Proceedings: Bell Operating Company Safeguards; and Tier 1 Local Exchange Company Safeguards, 6 F.C.C.R. 174, 178 at ¶ 25 (1990) ("Under price cap regulation, the BOCs are no longer automatically entitled to increase rates to recoup cost increases as they would have been under a cost-plus rate of return system of regulation. Instead, rate levels are adjusted to reflect inflation and anticipated efficiency gains by BOCs. Thus, unlike under rate-of-return regulation, any misallocation of nonregulated costs to regulated operations under price cap regulation normally would not permit higher prices and increased earnings. Rather, any such additional costs would merely reduce BOC earnings.")

10 The Commission evidently agrees. See id. ("Although reducing cross-subsidy incentives, LEC price cap regulation does not by itself eliminate improper cost allocation as a matter of regulatory concern, but serves as an effective complement to cost accounting, reporting, auditing, and enforcement safeguards.").

11 Leland L. Johnson, Ph.D., Reply Comments: Allocating Common Costs to Avoid Cross-Subsidy and Enable the Sharing of Benefits, at 6 [hereinafter "Johnson, Reply Comments: Allocating Common Costs"].

price caps of the LEC to protect ratepayers. On the other hand, chronic losses or profit levels which impair the LEC's ability to attract capital signal the need for an increase in the firm's price caps. As Dr. Johnson notes:

> Pure price caps do not exist nor can they reasonably be expected to exist because regulators cannot ignore the company's profits and losses. If profits are persistently high, regulators would be under strong public pressure to revise the price cap formula. Conversely, low profit levels or losses would bring pressure to adjust the formula in the other direction.[12]

If a LEC can artificially increase the costs of providing regulated services in order to decrease its nominal profits, and can maintain the high-cost levels for an extended period of time, it likely will receive a price cap increase following its periodic review (or avoid a price cap decrease).[13] The price cap increase (or the avoidance of a decrease) will enable the LEC to continue allocating the losses of its competitive ventures to its regulated activities while simultaneously charging local ratepayers higher rates to cover those costs. Obviously, the only winner in this scenario is the LEC.[14]

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[12] Id. at 7.

[13] Of course, the costs of the LEC will have to survive regulatory scrutiny to have any effect on price caps, but the ability of LECs to justify costs is well-developed.

[14] Bell Atlantic cites a previous filing by Professor Kahn to support the proposition that a LEC regulated under price caps "is no more able to cross-subsidize than an unregulated firm." Comments of Bell Atlantic at 2, citing Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Reply Comments of Bell Atlantic, Affidavit of Alfred E. Kahn, June 28, 1994, at 13. Bell Atlantic appears to have taken this quotation out of context. Professor Kahn stated in his affidavit:

> In its pure form direct price regulation eliminates any entitlement of regulated companies to recover from monopoly customers any reductions in rate of return resulting from price cuts in competitive markets. It correspondingly eliminates any incentive of the regulated companies to shift costs from unregulated or competitive to less competitive services. Under price caps -- or any form of incentive regulation that breaks the link between observed costs and prices -- the LEC is no more able to cross-subsidize than an unregulated firm: if it invests money in the destruction of its rivals, it will have to absorb that investment as a reduction in its earnings and hope to recoup its losses later under more favorable circumstances

Price cap profit sharing mechanisms create similar incentives. Sharing mechanisms require LECs to share with ratepayers a portion of their profits above a certain profitability level. At greater levels of profitability, LECs in a sharing regime are required to share 100 percent of their profits with ratepayers.

Under some circumstances, the sharing mechanisms operate as rate of return regulation by creating incentives for LECs to avoid entering the levels of profitability where they must share profits with ratepayers, if at all possible. Rather, the economically rational preference is to realize 100 percent of profits. The realization of 100 percent of profits (or as close to 100 percent as possible) may be achieved by absorbing nonregulated costs into regulated accounts (or by absorbing regulated revenues into nonregulated accounts) thereby "increasing" profitability for the nonregulated activity. The absorption of nonregulated costs into regulated accounts (or regulated revenues into nonregulated accounts) decreases the profitability levels of the LEC's regulated activities, thereby enabling the LEC to avoid sharing profits with ratepayers (and, if this activity is maintained over a period of time, will assist the LEC in maintaining higher price cap levels).

Id. (emphasis supplied). Professor Kahn previously explained that a "pure" price cap scheme -- one in which the "link" between prices and costs is permanently severed -- does not exist in the real world. As Professor Kahn observes, a "pure" price cap scheme is an arrangement in which the government surrenders "for all time" the option of reviewing the regulated carrier's rates. Professor Kahn states, "permitting a carrier to change its choice of X-Factor annually could create opportunities for abuse." In the Matter of Price Cap Performance Review for Local Exchange Carriers, 10 F.C.C.R. 13659, 13678, at ¶¶ 119-120 (1995). We note that a pure price cap is defined in terms of the possibility of review, and not the presence or absence of "sharing." Since its rates are subject to review, Bell Atlantic is not operating under a pure price cap. It follows that, in contrast to the unregulated firm, absent regulatory supervision Bell Atlantic is quite able to cross-subsidize.

An additional concern regarding incentives for cross-subsidization under price caps arises from the jurisdictional separation of authority for rate regulation. Because LECs are subject to rate regulation at both the state and federal levels, a LEC which chooses not to engage in sharing at the federal level may nonetheless retain its cross-subsidization incentives as a result of sharing at the state level. Further, while the Commission may be able to vigorously enforce against LEC attempts to cross-subsidize, the state regulatory commissions may not enjoy similar abilities. As a result, the incentives for LECs to attempt cross-subsidization will remain until effective competition can eliminate their ability to act on those incentives.[15]

B. The Unprecedented Level of Common Costs Resulting from the Dual Provision of Video and Telephony Mandates a Fixed Cost Allocation Factor.

As the Commission stated in the Notice, it is likely that the use of integrated networks to provide video and telephony will result in economies of scope.[16] The economies would be made possible, in large part, by the extremely high level of costs common to both the provision of video and the provision of telephony. While these common costs can generate benefits for

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[15] See Johnson, Reply Comments: Allocating Common Costs, at 12 ("'Evolving market pressures are reducing the ability of LECs to cross-subsidize' because 'the pool of potential LEC monopoly revenues available to absorb cost shifting is shrinking. . . . [T]he threat of cross-subsidy is less today than previously, and it will continue to diminish.' Nevertheless, the threat today remains substantial because of the monopoly still held by the LECs."). Dr. Joseph Farrell seems to agree. Bell Atlantic quoted Dr. Farrell as saying that the Commission should "stop trying to allocate costs." See Comments of Bell Atlantic, at 3 (citing Communications Daily at 2 (May 22, 1996)). Actually, this quote was taken out of context. Dr. Joseph Farrell asserted that the elimination of cost allocation is a long run answer, one to be pursued only after LECs no longer possess market power and effective local exchange competition exists. NCTA believes this position is consistent with that of Dr. Johnson.

[16] See Cost Allocation Notice at 15, ¶ 35 ("We do know, however, that if the provision of a hybrid system is an economically efficient business decision, it will include economies of scope.").

ratepayers and LECs alike, they can also cause harm if the cost allocation system fails to achieve clear delineation of costs and easily administered methods of allocation.

The Commission will likely find that the development of integrated networks will increase those network costs which are not directly assignable. Yet, to protect local ratepayers, the Commission must properly allocate the costs of the integrated networks. The tension that exists between the decreasing ability to directly assign integrated network costs and the importance of avoiding cross-subsidization by properly assigning common costs will be relieved only by an easily applied fixed cost allocation factor [17]

C. **Cost Allocation Rules Are Necessary For LECs to Certify That Their OVS Transmission Rates Are Just and Reasonable.**

Cost allocation rules are necessary not only for the protection of local telephone ratepayers, but also for the provision of competitive Open Video Systems ("OVS"). An operator of an Open Video System must certify to the Commission that its charges for carriage of video programming are just and reasonable.[18] Traditionally, the Commission has treated the concept of "just and reasonable" prices as requiring some proximity to cost.[19] The absence of cost allocation methods will prevent LECs operating OVS from certifying that OVS transmission

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[17] See In the Matter of the Ameritech Operating Companies, 10 F.C.C.R. 5606, 5606 ¶ 2 (released March 3, 1995)("As the telecommunications marketplace continues to diversify, with carriers providing more and more nonregulated services, our enforcement of accounting safeguards will become even more important if we are to continue to protect ratepayers from being overcharged for . . . services.").

[18] 47 U.S.C. § § 653(a) and 653(b)(1)(A).

[19] See, e.g., In the Matter of Investigation of Special Access Tariffs of Local Exchange Carriers, 4 F.C.C.R. 4797, 4800, at ¶ 32 (1988) ("Costs are traditionally and naturally a benchmark for evaluating the reasonableness of rates . . . . Our requirements for cost support and rejection of rates which would exceed costs, without valid cause, reflect the importance of costs to any evaluation of rates.").

charges are just and reasonable. Similarly, without cost allocation rules (and the underlying knowledge of OVS costs), the Commission will have no consistent method of fulfilling its statutory obligation to ensure that OVS transmission charges are just and reasonable.

The example of OVS emphasizes the increased need for cost allocation rules as competition develops in new services. As LECs devote an increasing percentage of their resources to nonregulated services, the incentive to cross-subsidize will increase. Further, as an increasing number of nonregulated services are offered over the integrated network, the opportunities for cross-subsidization also will increase. In order to control these forces, the Commission must develop clear cost allocation rules, using a fixed allocation factor for common costs, to minimize the administrative burdens while increasing administrative effectiveness in the face of telecommunications competition.

In sum, the LECs continue to resist the need for and role of clear cost allocation rules. Without effective cost allocation procedures, local telephone ratepayers would be transformed into unwilling LEC shareholders by forcing them to underwrite the competitive ventures of the LECs. Instead, the Commission should expeditiously adopt well-defined cost allocation rules, as proposed in NCTA's comments, to protect local ratepayers from cross-subsidization.

III. SCOPE ECONOMIES SHOULD BE SHARED WITH LOCAL RATEPAYERS

In their comments, the LECs uniformly assert that the productivity factor used in calculating their price caps sufficiently shares with local ratepayers the benefits of any scope economies resulting from network integration.[20] Hence, they argue, to require further that they

[20] See, e.g., Comments of Bell Atlantic at 5 ("The Commission's goal of providing telephone ratepayers 'some of the benefit of the economy of scope between telephony and competitive services' is already accomplished through adjustments to the 'x-factor' productivity offset."); Comments of NYNEX at 23

pass some of the benefits of scope economies to local ratepayers would constitute double counting.[21]

These arguments are incorrect. Costs and revenues from nonregulated services do not factor into LEC price cap indices. LECs have the incentive to direct any network integration efficiencies in their nonregulated services, and realization of these unanticipated efficiencies would not be included in price cap indices. Thus, any extraordinary economies of scope from network integration will not lower local telephone rates without regulatory intervention.

As NCTA stated in its comments, because local telephone ratepayers have underwritten the research and development used to develop the backbone network, they have contributed substantially to the structure which will make possible the scope economies of an integrated network. As such, local ratepayers should share in any integrated network efficiencies which are not reflected in current price cap indices.

The LECs argue that current productivity factors would constitute sufficient sharing mechanisms despite their inability to determine the levels of productivity which may result from

("The proposed X-Factor in the LEC price cap formula is designed to capture total company productivity growth, including nonregulated activities, provided on an integrated basis with regulated activities."); Comments of United States Telephone Association at 13 ("The moving average Total Factor Productivity methodology, which the Commission tentatively concluded should be adopted for its long term price cap regulation, reflects the economies of scale achieved through the provisioning of regulated and nonregulated services over a shared system.").

[21] See, e.g., Comments of BellSouth Corporation at 9-10 ("Expanding the scope of Section 61.45(d)(1)(v) to attempt to capture economies of scope resulting from the offering of new nonregulated services over the public telecommunications network would double count this source of productivity."); Comments of United States Telephone Association at 13 ("Requiring an exogenous reduction for the same economies of scale already included in the TFP . . . would result in a double reduction.").

network integration.[22] The Commission should recognize that the price cap indices may need to be adjusted over time in order to account for greater than anticipated technological progress. The precise level of sharing will, of course, depend upon the levels of increased productivity. However, to the extent that the LECs enjoy economies of scope from network integration, the benefits should be shared with local ratepayers by appropriately adjusting the price cap indices.

IV. ADOPTION OF THE NCTA COST ALLOCATION PROPOSAL WILL NOT UNDERMINE INCENTIVES TO CONSTRUCT BROADBAND NETWORKS, BUT WILL INSTEAD PREVENT UNECONOMIC CROSS-SUBSIDIES FROM HARMING LOCAL RATEPAYERS AND DISTORTING COMPETITIVE MARKETS

The comments of the incumbent LECs warn that vigorous protection against cross-subsidization to competitive activities, such as the provision of video services, will destroy incentives for LECs to offer such services. In principle, it is true that the removal of economic incentives to engage in an activity will discourage profit-seeking entities from entering the field. This principle, however, is quite different from the arguments made by the LECs. Quite to the contrary, by criticizing appropriate cost allocation methods, the LECs encourage the Commission to distort the market through the creation of artificial economic incentives by misallocation of common costs. The Commission must avoid this course as a matter of sound economic policy and adherence to statutory requirements[23]

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22 In fact, it is arguable that current productivity factors do not adequately reflect the true productivity of the network today. See Johnson, Reply Comments: Allocating Common Costs at 6-7 ("[T]he Commission currently permits carriers to select a new X-Factor annually. It is aware that 'permitting a carrier to change its choice of X-Factor annually could create opportunities for abuse,' and it is inquiring into the issue of how much flexibility the LECs should have to change their selections.") (citing In the Matter of Price Cap Performance Review for Local Exchange Carriers, 10 F.C.C.R. 13659, 13678, at ¶¶ 119-120 (1995).).

23 See 47 U.S.C. § 254(k).

A. LEC Complaints About Overallocation of Costs to Competitive Services Are Actually Complaints About the Removal of Their Uneconomic Cross-Subsidies

LECs would minimize the allocation of costs to the provision of competitive services (or to avoid cost allocation altogether). These efforts are attempts, veiled and not-so veiled, to preserve the opportunity to cross-subsidize their competitive efforts with the rates of local telephone customers.[24] For instance, in contrast to other LECs, U S WEST's plans to cross-subsidize are refreshingly "above board." In an admission that it intends to cross-subsidize and to force telephone ratepayers to fund nonregulated video investments, U S WEST states:

> If the Commission errs too far on the side of protecting the regulated ratepayer, there likely will be nothing to cross-subsidize. In other words, excessive measures that go too far in preventing cross-subsidization would stifle LEC participation in the delivery of video programming services to consumers, and would in turn deprive consumers of choices that the 1996 Act is designed to create. Comments of U S WEST, Inc. at 4

Development of video provision capabilities will be an expensive undertaking on a stand-alone basis, as NCTA members can attest. Still, the financial obstacles to the development of integrated networks are not insurmountable, particularly if the projected benefits are sufficiently large to attract the necessary capital investments. Regardless, the viability of providing video services over integrated networks should not and cannot be permitted to depend

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[24] For example, in their comments, NYNEX, U S WEST, Inc. and Southwestern Bell propose cost allocation methods which would severely overallocate costs to telephony by applying the allocation factor only to those customers who take both video and telephony service from the LEC. See Comments of NYNEX at 13; see also Comments of U S WEST, Inc. at 11; see also Comments of Southwestern Bell Telephone Company at 6. For example, if cable penetration in the LEC's market was at the national average of 70 % and if the LEC was able to attract 50% of that market, that would mean that 35% of all telephone subscribers in that LEC's territory would also be taking video service from the LEC (assuming the LEC enjoyed 100% market share for local telephone service). The use of a 50% allocation factor, as recommended by U S WEST, would result in an allocation of 82.5% of common costs to telephony and 17.5% of common costs to video. This is an entirely inappropriate result because it would assure that telephone ratepayers, rather than shareholders, assume the risk of LEC video investments

upon cross-subsidies from local telephone ratepayers. Rather, the viability of integrated network construction must stand or fall without coerced financial assistance from local ratepayers. To permit otherwise would not only severely distort market-based incentives for entering competitive fields, but would also violate the Commission's mandate to protect the public interest.

However, cross-subsidization of the magnitudes apparently contemplated by the LECs is inconsistent with the Telecommunications Act[25]. Congress considered the issue and confirmed the goal of protecting telephone ratepayers against cross-subsidies. The benefit of market entry by new LECs under the 1996 Act (for instance, in cable service by repeal of Sec. 613(b) or interexchange service under Sec. 271 is not to come at the expense of telco ratepayers; the ratebase was not to be converted to a venture capital fund. That is what shareholder equity is designed to do.

The offering of services such as OVS are not worth the economic distortion and social inequities that would accompany ratepayer cross-subsidies. That is why this Commission's expedited effort to insure the provision of video services by ILECs over integrated networks accomplished consistent with sound economic principles is so important.

B. The NCTA Proposal Will Maintain Proper Economic Incentives to Construct Broadband Networks While Protecting Local Ratepayers

The NCTA cost allocation proposal provides the requisite balance to permit the provision of competitive video services while simultaneously protecting local ratepayers in an economically sound fashion. Using the economic analysis of Dr. Johnson, NCTA, along with

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[25] See n.23, supra.

several other commenters, proposed an allocation of 75% of common costs to video services and an allocation of 25% of common costs to telephony. To fully ensure that local ratepayers are protected against cross-subsidies, NCTA further recommended measuring the incremental costs of providing video services over an integrated network by using the stand-alone costs of a state-of-the-art telephone network as a ceiling. This will ensure that no more costs are allocated to the telephone side of the network than would be the case in the absence of an integrated network. Finally, NCTA recommended reductions in LEC price cap indices so that local ratepayers would share in the scope economies provided by integrated networks.

The NCTA proposal is sound because it provides a mechanism to ensure that competitive markets operate on the basis of market incentives. Injection of cross-subsidies into competitive markets would result in artificially low costs for LEC video operations, thereby granting them an uneconomic competitive advantage. In the long run, the dominant player in the cross-subsidized field would not be the most efficient provider of the competitive services but rather a less efficient provider with artificially low costs. In their opposition to a mandatory bill-and-keep compensation structure for local call termination, the same LECs promoting cross-subsidies in this proceeding ironically emphasize the importance of sending the proper pricing signals to realize the economically efficient use of the network.[26] The proper course is clear; the

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[26] See In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act, CC Docket No. 96-98, Comments of Ameritech at 85 (May 16, 1996)("The principle of efficient competition requires that entrants and incumbents alike recognize and pay for the costs of resources they use in the construction and operation of their businesses. If prices for facilities and services supplied by the incumbent LEC are too low, it will encourage inefficient entrants to enter downstream markets. . . . In contrast, setting prices too high will discourage entry by efficient providers of retail services while encouraging the entry of inefficient providers of interconnection and network elements."); see also In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act, CC Docket No. 96-98, Reply Comments of BellSouth Corporation at 36 (May 30, 1996) ("The pricing standard in the Act requires that a LEC's charges for interconnection

Commission should pursue sound economic policy by preventing the injection of cross-subsidies into competitive markets in accordance with the NCTA proposal.

V. CONCLUSION

NCTA encourages the Commission to recognize the necessity of cost allocation rules to prevent cross-subsidization and to continue its efforts to preserve universal service by adopting the cost allocation proposal of NCTA contained herein and in its initial comments in this docket.

Respectfully submitted,

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June 12, 1996

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and unbundled elements be cost based. The plain and obvious meaning of the Act is that such charges reflect actual costs."); see also In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act, CC Docket No. 96-98, Comments of United States Telephone Association at 38 ("[A] national formula could not take account of market . . . conditions. . . . Prices will be too high in some areas and for some services . . . and too low in other instances (inviting inefficient entry).").

ATTACHMENT A

REPLY COMMENTS: ALLOCATING COMMON COSTS TO AVOID CROSS-SUBSIDY AND ENABLE THE SHARING OF BENEFITS

Leland L. Johnson, Ph.D.[1]

Summary

This reply in the Commission's proceeding on cost allocations[2] focuses on four considerations: (1) Dr. William E. Taylor's[3] discussion of the costing methodology proposed by Southern New England Telephone Company (SNET) demonstrates clearly the threat of cross-subsidy. (2) Contrary to the views of Dr. Taylor and Mr. J. Gregory Sidak,[4] price caps do not provide sufficient protection against the threat of cross-subsidization. Consequently Commission-mandated cost allocations between regulated and nonregulated services continue to be needed. (3) With or without price caps, the local exchange market is not sufficiently competitive to warrant the abolition of cost allocations as a regulatory tool. While competitive pressures are mounting in business markets, as Mr. Sidak emphasizes, the core monopoly held by the LECs, most notably in residential and small business markets, remains. (4) The loosening

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[1]My resume, describing my professional experience and other qualifications, is attached to my Declaration, appended to National Cable Television Association Opposition to Direct Case. *Amendment to the Bell Atlantic Telephone Companies Tariff FCC No. 10;* November 30, 1995.

[2]*Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services*, Notice of Proposed Rulemaking, CC Docket No. 96-112 (released May 10, 1996) ("Notice").

[3]Affidavit of Dr. William E. Taylor, appended to Comments of the Southern New England Telephone Company, May 31, 1996.

[4]Affidavit of J. Gregory Sidak, appended to Comments of the United States Telephone Association, May 31, 1996.

of regulatory constraints is a matter of timing. While the threat of cross-subsidy is less than in years past -- when the LECs had total hold in local exchange markets -- the remaining core monopoly necessitates continued regulatory intervention in cost allocations and elsewhere. As that monopoly erodes and eventually disappears, we can all happily anticipate the dismantling of government-imposed cost allocations and, more generally, deregulation across the board.

The Measurement of Incremental and Common Costs

It is a critically important to recognize that costs measured on the basis of the Commission's methodology[5] for assigning costs may vary greatly from the costs based on economic principles. Consequently, while an allocation of common costs between telephony and video of, say, 50 percent to each might appear reasonable if the common costs in question are properly measured in accordance with economic principles, the same 50 percent allocation could be quite unreasonable -- by directly generating a cross-subsidy -- if common costs are measured in terms of the Commission's methodology.

This point is well illustrated in Dr. Taylor's description of the costing procedures proposed by SNET for regulated telephony and non-regulated cable television services on its future hybrid fiber-coaxial (HFC) network. In describing the agreement between SNET and its cable affiliate, Personal Vision, he says that

> "[t]o comply with the FCC's requirements, SNET is required to assign to the Agreement prices all of the directly assignable costs plus an allocation of common costs .... From an economic perspective, removal of these direct costs from the regulated entity ensure that Personal Vision does not receive a cross-subsidy because the terms of the Agreement exceed the forward-looking incremental cost of the service."[6]

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[5]The Commission's methodology is described in the Notice, *supra*, at 6-9.

[6]Taylor Affidavit at 9.

A fundamentally troubling aspect, however, is that the "directly assignable" costs identified by SNET probably fall short -- quite possibly far short -- of the economically relevant incremental cost of video, leaving intact a threat of cross-subsidy. To demonstrate, I shall use the terms "incremental cost (accounting)" to denote the costs directly assigned with SNET's accounting techniques; "incremental cost (economic)" to denote the incremental cost measured on the basis of economic principles; and "common cost (accounting)" and "common cost (economic)" to denote respectively the common costs measured in terms of accounting and economic principles. Moreover, I use the term "video" generically to include all unregulated broadband services such as high speed data, including high speed access to the Internet. In other words, "video" encompasses all non-regulated services that cannot be satisfactorily accommodated on narrowband telephone networks.

In accordance with the Commission's methodology, SNET takes the directly assignable cost of video as the cost of identifiable video components added to the HFC network. This directly assignable cost is interpreted as the cost "caused" by video -- the incremental cost of video (accounting). However, video incremental cost (accounting) would be equal to video incremental cost (economic) only if the HFC network would have been built even in the <u>absence</u> of video. That is, SNET would scrap its existing telephone network in favor of a new HFC network for telephony on a stand-alone basis. I have seen no evidence that SNET would do so. On the contrary, SNET's overarching motivation, like the motivation of other LECs that have proposed integrated telephony/video networks, is to enter the wireline video market -- not to replace in the near future its existing telephone network.

In terms of economic principles, the incremental cost of video (economic) is the difference between the cost of the integrated network and the <u>least costly</u> telephone network (of equivalent service quality) that would otherwise have been used on a stand-alone basis. Such a network would reasonably be expected to consist of upgrades to today's networks -- or in new communities, perhaps, to new digital loop carrier telephone networks -- as described in my previous comments.[7] The true cost "caused" by video -- its incremental cost (economic) -- is far greater than the incremental cost (accounting), because SNET measures the stand-alone cost of telephony as the cost of the HFC network minus video instead of considering the much less costly upgrade of the existing telephone network.[8]

Consequently, the fact that SNET assigns the direct cost of video -- video incremental cost (accounting) -- plus a share of common cost (accounting) to video, does not necessarily mean that no cross-subsidy exists. Since video incremental cost (accounting) falls below incremental cost (economic), some portion of common cost (accounting) must be allocated to video to compensate for the shortfall, if cross-subsidy is to be avoided. Moreover, an additional common cost allocation to video is required if telephone ratepayers are to be assured of sharing the benefits of the economies of scope. Whether SNET's proposed 50 percent allocation of common cost (accounting) is sufficient cannot be determined in the absence of the specific cost magnitudes involved in SNET's case.

In short, the appropriate formula for allocating common costs depends on how common costs are computed in the first place. If they are based on economic principles, Dr. Taylor is

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[7] *Allocating Common Costs to Avoid Cross-Subsidy and Enable the Sharing of Benefits*, appended to *Comments of the National Cable Television Association* in response to Notice (May 31, 1996) at 5,7. Some LECs have sought to defend the notion that the integrated network would enable substantial reductions in operating and maintenance costs for telephony in comparison with conventional telephone stand-alone networks. However, no detailed basis for this assertion has appeared in the record, to my knowledge, nor is it at all clear that such reductions would occur in comparison with upgrades to existing networks or with new digital loop carriers.

[8] As an extreme case, if the existing network could provide at no additional cost the same telephone services as the HFC network over the lifetime of the HFC network, the entire cost of the HFC network would be incremental to video, since its entire construction would have been caused by the LEC's desire to enter the video market.

correct in saying that "[a]ll economists recognize that after incremental costs are directly assigned on the basis of cost-causation, the assignment of the remaining common costs to services, on any basis, is arbitrary [footnote omitted]."[9] However, if incremental and common costs are measured in terms of the Commission's methodology, and adopted by SNET, the allocation of common costs is not arbitrary since the way they are allocated will determine whether cross-subsidy exists. As I concluded in my earlier comments, data from Pacific Bell and Bell Atlantic suggest that more than 50 percent of common costs (accounting) should be allocated to video to meet the Commission's objectives of avoiding cross-subsidy and sharing the benefits from scope economies.

Price Caps as an Inadequate Safeguard Against Cross-Subsidization

The mistaken notion that price caps greatly reduce or eliminate the danger of cross-subsidization has played a prominent role in past regulatory proceedings. Not surprisingly, price caps emerge in the present proceeding as a factor that, allegedly, obviates the need for any Commission-imposed cost allocations. Thus, Mr. Sidak concludes that "[t]he Commission would best serve the public interest in this proceeding by exercising its new authority to forbear from applying the cost allocation provisions of Part 64 to any LEC subject to price-cap regulation that does not include earnings sharing."[10] Defining "pure" price caps as those with no sharing arrangements, Dr. Taylor similarly concludes that "there is no need to perform arbitrary cost allocations for those firms under price cap regulation -- especially pure price cap regulation --

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[9]Taylor Affidavit at 3.

[10]Sidak Affidavit at 20.